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Procyclicality in Basel II: Can we treat the disease without killing the patient? ☆

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Abstract

The debate over the potential procyclicality of bank capital requirements under Basel II has focused overwhelmingly on peak-to-trough variation in minimum regulatory requirements. In this paper, we re-examine the problem from the perspective of market discipline. First, we show that the marginal impact of introducing Basel II depends strongly on the extent to which market discipline leads banks to vary lending standards procyclically in the absence of binding regulation. Second, we evaluate policy options not only by their efficacy in dampening cyclicality in capital requirements, but equally by how well the information value of Basel II market disclosures is preserved.
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Academics, practitioners and policy makers have commented on the potential procyclicality of the New Basel Capital Accord (Basel II). So long as bank rating systems are responsive to changes in borrower default risk, capital requirements under the Internal Ratings Based (IRB) approach will tend to increase as an economy falls into recession and fall as an economy enters an expansion. To the extent that banks curtail (expand) lending in response, recessions (expansions)

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will be amplified. Thus, many have argued that the New Accord will make it more difficult for policy makers to maintain macroeconomic stability.

In this paper, we re-examine the procyclicality issue from the perspective of market discipline. First, in trying to assess the likely magnitude of the problem, we show that the marginal impact on procyclicality of introducing the New Accord depends strongly on a question that earlier studies have not considered: To what extent does market discipline lead banks to vary lending standards procyclically in the absence of binding regulation? Second, can we identify policy options that will serve to lessen cyclicality in capital requirements while still preserving the informativeness of Basel II market disclosures? Put another way, can we dampen procyclicality without garbling the signal?

Our concerns and the manner in which we address them are best understood in the context of the goals and "three pillar" structure of the New Accord. Pillar 1 is a regulatory standard for minimum capital requirements. The primary objective under Pillar 1 is better alignment of regulatory capital requirements with "economic capital" demanded by investors and counterparties. In the final Basel II agreement (Basel Committee on Bank Supervision, hereafter BCBS, 2004), as in earlier drafts, the great bulk of the documentation is devoted to the rules for determining minimum capital requirements, and it is this aspect of the New Accord that has drawn the most commentary from practitioners and academics.[1] In particular, the burgeoning literature on the procyclicality of the New Accord is written mainly from the perspective of Pillar 1. That is, the focus is on estimation of the likely range of variation in regulatory capital requirements from peak to trough in a business cycle, and on how modifications to the capital formula might increase or decrease this variability.

Pillar 2 is the supervisory review process. The New Accord sets forth broad principles and some specific guidelines for review of capital adequacy that are intended to push both banks and supervisors beyond mechanical application and satisfaction of Pillar 1 standards. Banks are expected to establish and document internal processes for assessing capital adequacy relative to portfolio risk. The intent of the Basel Committee (BCBS, 2004, §757a) is that large, internationally active banks will choose for their own competitive reasons a level of creditworthiness that exceeds that embodied in Pillar 1 standards, which corresponds approximately to a BBB− rating.[2] Furthermore, banks' internal processes are expected to include consideration of interest rate risk, liquidity risk, concentration risk, and other risks not explicitly addressed under Pillar 1. Therefore, "[s]upervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum" (BCBS, 2004, §756). Regulatory capital requirements should properly be viewed as a composite of formulaic Pillar 1 rules and judgmental Pillar 2 buffers, so the volatility of regulatory capital over the business cycle will depend in practice on whether supervisors guide Pillar 2 buffers in a manner that offsets or augments changes in Pillar 1 requirements. Borio et al. (2001) and

[1] Very few academic discussions of the New Accord place any emphasis on Pillars 2 and 3. Decamps et al. (2004) analyze the role of supervisory review and market discipline as a complement to minimum capital requirements in an optimal supervisory regime.

[2] At face value, the 99.9% target solvency probability to which the New Accord is calibrated would appear more consistent with a rating of A− or BBB+. However, both the current Accord and Basel II permit limited recognition of subordinated debt and other non-equity liabilities towards the regulatory capital requirement. Such instruments may limit the burden on deposit insurance funds in the event of a bank insolvency, but do not lower the probability of such an insolvency and therefore do not constitute economic capital.

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